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SUBJECT: LORD TURNER: REFORM UK REGULATORY FRAMEWORK AND END LIGHT TOUCH REGULATION

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¶1. (SBU) Summary: Lord Turner, chairman of the Financial Services Authority (FSA), recommended an overhaul of the UK's regulatory regime and an end to its "light touch" approach to supervision, in his review of the causes of crisis and recommendations for strengthening the banking sector. Turner stressed the importance of reforming capital adequacy and liquidity requirements, introducing macro-prudential analysis, and overhauling the FSA's regulatory approach ? making it more intrusive and more systemic. He called for reforms to remuneration structures, credit rating agencies, and off-balance sheet vehicles and introduced the idea of product regulation. Reaction to the report was mixed. Banking and business groups largely welcomed his ideas while the Liberal Democrats and unions dismissed them as being more rhetoric than substance. His review, published March 18, is likely to be used as the basis for the UK's negotiations at the upcoming G20 Summit. End summary.

Background

¶2. (SBU) Lord Turner, chairman of the FSA, was asked by Chancellor Darling in October 2008 to review the causes of the current financial crisis and to make recommendations on the changes in regulation and supervisory approach needed to create a more robust banking system. His review, published March 18, is part of the UK's attempt to set the global regulatory agenda for both the G7 and G20 groups and is likely to be used as the basis for the UK's negotiations with the G20 April
¶2. Turner's recommendations would overhaul the UK's financial regulatory regime and end its "light-touch" approach. His report identified three underlying causes of the crisis: macroeconomic imbalances, financial innovation of little social value, and deficiencies in bank capital and liquidity regulations. It proposed recommendations to reform all aspects of regulation from capital and liquidity to remuneration structures.

Capital and Liquidity Recommendations

¶3. (U) Turner's report stressed the importance of reforms to capital adequacy and liquidity requirements in creating a sounder banking system. It called for increased quantity and quality of bank capital, with a focus on Tier 1 and Tier 2 capital for systemically important banks, allowing the banking system to better absorb future shocks. Additionally, Turner recommended an intensification of liquidity regulation and supervision to contain liquidity risks through the creation of counter-cyclical capital buffers, with

capital levels increasing during booms and decreasing in recessions. This, Turner said, would stabilize the banking system through the cycle. He also discussed introducing measures to avoid the procyclicality in Basel 2 implementation.

Macro-Prudential Analysis

¶4. (U) A system-wide macro-prudential perspective is vitally important to prevent a repeat of the current crisis, according to the report. Turner suggests the G20 leaders will need to turn high-level commitments to improved early warning systems, surveillance and peer review into robust international arrangements which empower the IMF to produce independent analysis of system-wide risks. Macro-prudential analysis should identify trends in the economy and the financial system which have implications for financial and macroeconomic stability. In the UK, prior to this crisis, there was an "underlap" of supervision such that neither the Bank of England nor the FSA looked at system-wide risks. The FSA focused on the supervision of individual institutions while the Bank focused on monetary policy analysis without forming policy responses to offset the risks identified. Going forward, Turner recommended the Bank of England and FSA work together to conduct macroeconomic analysis and gather insight from specific institutions and business model analysis.

FSA Supervision: More Intrusive, More Systemic
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¶5. (U) A principles-based, light-touch approach to regulation and supervision will be replaced with

"intensive supervision." The FSA will devote more resources to supervising high impact firms, with increasingly frequent comprehensive risk reviews. Its supervisory style will shift from focusing on systems and processes to focusing on business outcomes, risk and the sustainability of business models. The FSA will have more intense contact with bank management and auditors in relation to public accounts and accounting judgment. Turner said the FSA will need to understand the assets and liabilities in bank balance sheets at a greater level of detail so it can properly understand business model risks.

Other Recommendations

¶6. (U) Turner set out a number of other recommendations in the report from remuneration policies to potential product regulation:

-- Remuneration policies should be designed to avoid incentives for undue risk taking. The FSA will examine the risk consequences of remuneration policies during its overall risk assessments. It will enforce principles that align remuneration policies with appropriate risk management.

-- Glass-Steagall type legislation that would enforce a greater institutional separation between commercial and investment banks is not needed. Turner said such a separation is not practical in today's complex global economy, nor is it clear it would radically reduce banking system risks.

-- The FSA will start consultations on the possibility of regulating products in both retail and wholesale markets. It will consider introducing maximum loan-to-value ratios or loan-to income ratios for mortgages and regulating wholesale market products that can adversely impact

financial stability.

-- Regulation should focus on economic substance, not legal form. Off-balance sheet vehicles which create substantive economic risk must be treated like on-balance sheet for regulatory purposes. Regulators should be given the power to apply prudential regulation to hedge funds if their activities become bank-like in nature or systemic in importance.

-- The FSA supports legislation currently being formulated in the EU that will require credit rating agencies (CRAs)to register with and be supervised by financial regulators, coordinated at a European level via colleges. Turner said supervisory oversight should require CRAs to only accept assignments where a consistent rating could be produced.

Reaction: Useful vs. Too Watered Down

¶7. (SBU) Turner's report was widely welcomed by business groups. A rush to legislation would have risked a repeat of a Sarbanes-Oxley type over-reaction, compounding the effects of the recession, according to the Confederation of British Industry (CBI). It praised Turner for producing targeted proposals dealing with specific failings and risks to the whole system, rather than responding to wilder calls for action against banks. The British Bankers' Association (BBA) told us the report was useful because it injects a practical element into the issues discussed within the various international fora. Paul Chisnall, the BBA's executive director of financial policy, said the BBA recognizes that work needs to be undertaken in the regulatory sphere to prevent another financial crisis on this scale. He told us the areas discussed in the report are mostly valid areas of consideration and that the BBA has no qualms with expanding the scope of regulation. The BBA encouraged the introduction of a macro-prudential element to supervision, making the financial sector more aware of broader systemic threats. Chisnall was particularly pleased Turner did not see any need for the introduction of Glass-Steagall type legislation. But despite its broad approval of the report, the BBA is eager for more discussion and consultation. Chisnall cautioned against veering too close to the headlines and introducing reform because an issue receives significant press attention. This is particularly true of potential regulation

governing mortgage products. He said the FSA needs to be careful not to create a rigid structure that is anti-competitive.

¶8. (SBU) In contrast, other groups thought the regulatory chief had not gone far enough, arguing the whole regulatory framework should be restructured in the wake of such a widespread crisis. Vince Cable, Shadow Chancellor for the Liberal Democrats, dismissed the review saying it was "little more than a watered down summary of policy changes" his party has been demanding for years. He criticized Turner's decision to not call for the separation of low-risk retail banks from high-risk investment banks. The UK's largest union, Unite, was equally unimpressed by the report, saying its recipe of "more rhetoric than substance" would do nothing to reassure bank customers or staff. Unite's national officer, Rob MacGregor, said the report leaves key issues unresolved and HMG and the FSA should be brave enough to set out a new radical regulatory framework.

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